Internal Rever e Service
memorandum

date: July 10, 1991

to: Mr. Harold Neutuch
Manhattan District Team Coordinator, Group 1874

from: Chief Branch 3, CC:FI&P

subject: Limitation on Deduction of Bond Premium on Repurchase

This is in reply to your request for Technical Assistance with respect to section 249 of the Internal Revenue Code. Section 249 provides that no deduction shall be allowed to the issuing corporation for any premium paid or incurred upon the repurchase of a bond, debenture, note, or certificate or other evidence of indebtedness that is convertible into the stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium on bonds or other evidences of indebtedness that are not convertible. However, this provision does not apply to the extent that the corporation can demonstrate to the satisfaction of the Secretary that the excess is attributable to the cost of borrowing and is not attributable to the conversion feature. In essence, section 249 treats a premium attributable to a conversion feature as the equivalent of a non-deductible payment in redemption of stock.

Section 1.249-1(a)(1) of the Income Tax Regulations provides that no deduction is allowed to the issuing corporation for any repurchase premium paid or incurred to repurchase a convertible obligation to the extent the repurchase premium exceeds a normal call premium.

Section 1.249-1(b)(1) of the regulations defines an obligation as any bond, debenture, note, or certificate or other evidence of indebtedness. A convertible obligation is one which is convertible into the stock of the issuing corporation or a corporation which, at the time the obligation is issued or repurchased, is in control of or controlled by the issuing corporation. Section 1.249-1(b)(2). The term "control" has the meaning assigned to it by section 368(c). Section 249(b)(2) of the Code.

A repurchase premium is defined as the excess of the repurchase price paid or incurred to repurchase the obligation over its adjusted issue price. Section 1.249-1(c)(1) of the

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regulations. Section 249(b) defines the adjusted issue price as the issue price (as defined in sections 1273(b) and 1274) increased by any amount of discount deducted before repurchase, or, in the case of bonds or other evidences of indebtedness issued after February 28, 1913, decreased by any amount of premium included in gross income before repurchase by the issuing corporation.

A normal call premium is defined as an amount equal to a normal call premium on a nonconvertible obligation which is comparable to the convertible obligation. Section 1.249-1(d)(1) of the regulations. A normal call premium on a nonconvertible obligation is a call premium specified in dollars under the terms of the obligation. Id. In addition, a call premium specified in dollars under the terms of a convertible obligation is considered a normal call premium on a nonconvertible obligation if the call premium does not exceed an amount equal to one year's interest increased by the amount of discount on the obligation deductible under sections 1.163-3 or 1.163-4 or reduced by the amount of issue premium includible in income under section 1.61-12(c). Section 1.249-1(d)(2).

Section 1.249-1(e) of the regulations provides that to the extent that the corporation demonstrates a repurchase premium is attributable to the cost of borrowing and is not attributable to the conversion feature, the general rule that no deduction is allowed upon conversion will not apply.

Section 414 of the Tax Reform Act of 1969, Pub. L. 91-172, 1969-3 C.B. 10, 83, added section 249 to the Internal Revenue Code. Congress was concerned that corporations were taking a deduction for the difference between the stated redemption price and the actual purchase price on convertible indebtedness. Congress felt that the amount of the premium in excess of the cost of borrowing does not represent an interest expense or deductible business expense, but rather is similar to an amount paid in a capital transaction. The corporation is repurchasing the right to convert the bonds into its common stock, much as it might purchase its stock. H.R. Rep. No. 413 (Part 1), 91st Cong., 1st Sess. 110-11 (1969), 1969-3 C.B. 269; S. Rep. No. 552, 91st Cong., 1st Sess. 149 (1969), 1969-3 C.B. 518. The Congress felt since a corporation may not deduct the costs of purchasing its stock as a business expense the same treatment should apply to the right to purchase its stock. Summary of Senate Amendments to H.R. 13270, Tax Reform Act of 1969, at pages 76-77 (1969).

In summary, section 249 of the Code prevents an issuer from taking a deduction when it repurchases bonds that are convertible into its own stock, or into stock of a corporation in control of or controlled by the issuer, because the transaction is, in essence, a transaction in the issuer's own stock. Congress determined that it was inappropriate to permit a deduction for excess bond premium paid by an issuer on bonds convertible into affiliate stock, where the affiliate would not be allowed a deduction and the issuer would not be allowed a deduction if the bond were convertible into its own stock.

The courts have also been unwilling to permit a deduction on transaction which are essentially capital in nature. In Chock Full O' Nuts Corporation v. U.S., 453 F.2d 300 (2nd Cir. 1971), the Court of Appeals held that the taxpayer could not claim a deduction for amounts attributable to the conversion feature of convertible debentures issued by it. The court recognized that capital transactions generally do not give rise to a deduction, and noted that:

> The Government's position is buttressed by the further fact that amounts paid for conversion privileges are usually attributable to equity transactions rather than to the cost of borrowing money. ... Thus, denial of a deduction under these circumstances would be in line with the policy of the Internal Revenue Code disallowing deductions for amounts paid in capital transactions. See, e.g., Int. Rev. Code § 249.

Id. at 305-306.

In Clark Equipment Company and Consolidated Subsidiaries v. U.S., 89-2 USTC ¶ 9471 (W.D. Mich. 1989), a wholly owned subsidiary corporation issued debentures that were convertible into the stock of its parent. Seven years later, the debenture holders received from the subsidiary stock of the parent corporation in exchange for the debentures. The District Court held that when the debenture holders exercised their conversion rights the subsidiary was not entitled to a deduction for the loss it incurred because the value of the stock exceeded the value of the debentures. The court, citing National Can Corporation v. U.S., 687 F.2d 1107 (7th Cir. 1982), stated that the exchange of the subsidiary debentures for parent stock was essentially a capital transaction.

In National Can, a corporation formed a wholly owned subsidiary which in turn issued debentures that were convertible into the common stock of the parent corporation. Upon presentation by the debenture holders, the parent corporation exchanged its common stock for the bonds issued by its subsidiary. The court held that section 249 of the Code did not apply because the issuer of the debentures was the subsidiary not the parent. However, the Court of Appeals looked at the Congressional purpose in enacting section 249 to deny the parent corporation a deduction equal to the excess of the fair market value of stock exchanged for convertible debentures. The court realized that the premium paid was due to the conversion feature of the debentures. "In effect, the corporation is repurchasing the right to convert the bonds into its common stock, much as it might purchase its stock." Id. at 1115. The court recognized that no deduction nor gain or loss is recognized on the receipt of money or other property in exchange for bonds. "The rule is already well established that a corporation realizes no gain or loss when it issues stock in satisfaction of a conversion obligation of its own bonds. There is no reason that use of a subsidiary should make any difference." Id. at 1116.

If you have any questions concerning the foregoing, please call James Canup at FTS 566-3287.